Diligent Effort

Three weeks ago, you received the second in a series of articles addressing the "diligent effort" duty that applies in most surplus lines transactions. The first article focused on the legal duty itself, in the context of the public policy that produced it. The second article focused on the question of who is to perform that statutory duty in a surplus lines transaction.

This series of articles discussed various important issues in dealing with **Section 981.004(a), Texas Insurance Code,** which states that surplus lines insurance can only be procured from an eligible surplus lines insurer if:

> "the *full* amount of *required* insurance ***cannot be obtained, after a diligent effort,*** from an insurer *authorized* to write *and actually writing* that *kind and class* of insurance in this state." [Emphasis added]

The first article provided an oversimplified, “rule-of-thumb” guideline for understanding of the effect of the statute: *"If the coverage sought is obtainable from an admitted carrier, a surplus lines policy for that coverage cannot be issued."* It also explained that the statutory phrases "cannot be obtained, after a diligent effort," taken together mean that something less than the impossible effort to make inquiry of 100% of the admitted market is required to satisfy the duty. It also explained that the extent of the required effort to determine "obtainability" is that of an undefined degree of "diligence."

The second article addressed the issue of who, in the typical surplus lines transaction, is required to make that "diligent effort." Recognizing that Section 981.004(a) doesn't specifically state which party in a surplus lines transaction is legally responsible for performing the "diligent effort" duty, another “rule-of-thumb” guideline was offered: *"For now, the wisest approach is for surplus lines agents to conduct their business on the assumption that the ultimate responsibility for satisfying the "diligent effort" duty belongs to them."* That approach is recommended because, even though there has been no Texas court decision directly answering the question, the Texas Department of Insurance and some state appellate courts have interpreted the statute as assigning the duty to the surplus lines agent, and not the retail agent.

This article focuses on the question of what degree of "effort" is sufficiently "diligent" to satisfy the "diligent effort" requirement.

What "Effort" Is Sufficiently "Diligent"?

There really is no one answer to that question. One Texas court has clearly told us "no effort" is not sufficient. But beyond that, the degree of effort that is sufficiently "diligent" to satisfy the requirement in Texas appears to be a fact question, not a legal question, that varies with the

circumstances of the particular transaction involved in the litigation or enforcement action that raises it.

Other states requiring the performance of a similar "diligent effort" duty are "all over the board" in specifying the required degree of "diligence." Many specify that the requirement is satisfied by a specific number of declinations from admitted carriers, such as three or even five. Many require that an "affidavit" attesting to the fact that the specified number of declinations has been received or merely that a "diligent effort" has been made, with the affidavit signed by the retail agent in some states, by the surplus lines agent in others, or even the insured in still another state. Some states require the affidavit or other form of proof be filed with the insurance regulatory agency, but within differing time frames; others require that it be maintained in either the retail or surplus lines agent's files and available for inspection. Some state insurance regulatory authorities maintain "export lists" of coverages determined by the regulator not to be available from the admitted market and which may be issued by surplus lines insurers without any "diligent effort" whatsoever, by either the retail or surplus lines agent.

The Texas statute itself provides no specific measure for the degree of diligence required such as is found in other states, indicating a legislative public policy preference for a more flexible approach. The Texas "case-by-case" "fact question" approach appears to recognize the almost infinite variety of real-world surplus lines transactions and the circumstances in which they occur, as well as the cost and market efficiency benefits the less proscriptive approach provides. The Texas Administrative Code supports that approach by providing in Rule 15.23(e) that the filing of policies or other detailed evidence of coverage with the Stamping Office "*is made in lieu of filing an affidavit of diligent effort or other evidence of diligent effort by the surplus lines agent to place the coverage with an admitted carrier.*" (Prior to the legislative creation of the Stamping Office, surplus lines agents were required to file "affidavits" evidencing the satisfaction of the duty.)

However, the Texas courts have thus far provided little additional guidance regarding how much "effort" is sufficiently "diligent," as very few cases have addressed the issue at all and even fewer have addressed it directly. The most often-cited Texas case is *First Bank & Trust of Groves v Kraehnke*, a 1987 Beaumont appellate court case, which merely tells us that the failure to make *any* “diligent effort” whatsoever is not legally sufficient and that such a failure is an "important, crucial and meaningful violation" of the Insurance Code.

By contrast, in the 2006 Dallas appellate case of *Prodigy Communications Corp. v. Agricultural Excess & Surplus Insurance Company*, the surplus lines agent's admission that he did not perform any "diligent effort" regarding the *primary* layer of the required insurance was found to be outweighed by the agent's extensive marketing effort regarding the *excess* layer of coverage and his discovery that neither admitted nor nonadmitted carriers would write it. The Court held that the agent had satisfied the "diligent effort" requirement regarding the *primary* coverage at

issue when he concluded, without more, that the *primary* layer of coverage was not obtainable from the admitted market because the *excess* layer, which normally should have been much easier to place, was not obtainable from either market.

The *Prodigy Communications* case was later reversed on appeal on other grounds, so its precedential value may be limited. Nevertheless, it suggests that at least the Dallas appellate court finds favor in the case-by-case approach in which it weighs the particular facts of each case and its reasoning raises some interesting questions. In effect, the Court held that the knowledge acquired by the surplus lines agent through a "diligent effort" regarding one coverage "obtainability" question could be applied to satisfy the same requirement for another "obtainability" question, at least if the two questions are as closely related as being elements of the same larger transaction.

If that's the case, would the Court be satisfied if, on a Monday, a surplus lines agent clearly satisfied the “diligent effort” duty regarding a particular requested coverage, and then, on the following Tuesday, the same agent relied solely upon Monday's “diligent effort” to satisfy the duty regarding a subsequent request from a different consumer for the identical coverage? If it were so satisfied, would the Court hold differently if the identical coverage was sought the following week, or month, instead of a mere twenty-four hours later? The even broader general question is whether the "diligent effort" requirement in any particular case may be satisfied merely by a surplus lines agent's reliance upon his or her marketplace knowledge and expertise acquired over time. In other words, could a surplus lines agent satisfy the “diligent effort” requirement merely by saying, "I've been doing this for twenty years, and I know from my everyday experience that the coverage the consumer was seeking is simply not offered by the admitted markets represented by the retail agent"?

Whether a court would be satisfied with recently-acquired specific knowledge, well-established experience and expertise, or even three clearly-documented declinations from authorized insurers remain a matter of speculation. Those questions and others remain for the courts to work out over time because the Legislature has, for many years, indicated its preference for the more flexible case-by-case approach.

Merriam-Webster's Collegiate Dictionary describes the word "diligent" as an adverb referring to something that is "characterized by steady, earnest, and energetic effort; painstaking." Courts often apply a "plain meaning of the words" test in interpreting statutes. Therefore, the words used by Webster's to define the term may carry at least some weight with regulators and courts as they attempt to measure the effort that has been made in a given cases, but even those words may well take on different meanings when considered in the context of any given surplus lines transaction.

Again, it is important to recall some points related to the scope of the "diligent effort" duty emphasized in the second article of this series. A basic legal principle is that the law does not

require a person to do the impossible. By virtue of his or her surplus lines agent license alone, a surplus lines agent is afforded no access to the admitted market upon which to make the "diligent effort" determination. Even in reliance upon that agent's underlying general P&C agent license or Managing General Agent license, the surplus lines agent's access to the admitted market is limited to those admitted insurers with which the agent holds an appointment. In the same manner, the retail P&C agent's access to the admitted market is also limited to only those admitted insurers with which that agent holds an appointment. It is thus practically and legally impossible for either the retail or the surplus lines agent to inquire of the entire admitted market whether the required insurance is obtainable. Therefore, the "diligent effort" that is required by the law applies only to those admitted insurers with which the retail P&C agent or, if applicable, the surplus lines agent (by virtue of that agent's underlying P&C agent or MGA license), has appointments.

Because what constitutes a "diligent effort" to make the determination whether a "required" policy of insurance is "obtainable" from the admitted market will likely be determined by the circumstances of each individual transaction, one “rule-of-thumb" guideline for surplus lines agents and their agency staff is: "Be aware (that the duty exists and assume that the responsibility is yours); be deliberate and consistent (in the manner you go about making the effort); make the appropriate effort (to the circumstances of the transaction); and communicate (in various ways, with the retail agent involved in the transaction).

The next article in this series will emphasize the importance of documenting the performance of the "diligent effort" duty and offer some ideas for doing so.